

C. THE ORGANIZATIONAL TEST UNDER IRC 501(c)(3)

1. Introduction

IRC 501(c)(3) provides that a corporation, community chest, fund or foundation may qualify for exemption if it is organized and operated exclusively for charitable purposes. The term "organized and operated exclusively" is retained from the Revenue Act of 1913 which provided that any "corporation or association organized and operated exclusively for religious, charitable, scientific, or educational purposes, no part of the net income of which inures to the benefit of any private shareholder or individual" was entitled to exemption from federal income tax.

The regulations merely tracked the Code through 1958. In 1959, the Service amended the regulations to include the "organizational" and "operational" tests currently in use. Both of these tests must be satisfied or the organization is not exempt.

The organizational test relates to an organization's articles of organization and will be the focus of this discussion. The operational test relates to the organization's activities. It should be remembered that a deficiency in the articles cannot be cured by the organization's actual operations. Conversely, an organization whose activities are not within the statute cannot be exempt by virtue of a conforming charter. Reg. 1.501(c)(3)-1(b)(1)(iv).

2. Organizational Forms

To qualify for exemption, the organization must be a corporation, community chest, fund or foundation. Under IRC 7701(a)(3) the term "corporation" includes associations. Thus, the typical nonprofit association formed under a constitution or by-laws, with elective officers empowered to act for it, is treated as a corporation for purposes of IRC 501(c)(3).

Where the purported organizing instrument is in the form of a constitution or articles of association, there should be some evidence that it was signed by people who thereby associated themselves under its terms since an association cannot be formed by a single individual, nor can articles of association be promulgated by the act of one individual.

In Fifth-Third Union Trust Co. v. Commissioner, 56 F. 2d 767 (6th Cir. 1932), the court held that the terms "fund" and "foundation" are used in the broad general sense and that a trust could establish exemption as a charitable organization.

An individual, partnership, or formless aggregation of individuals, however, cannot qualify for exemption under IRC 501(c)(3). If it is determined that no organization exists, the applicant will be advised that no ruling or determination letter can be issued.

3. Articles of Organization

To meet the organizational test an organization must establish on the basis of its articles that it was organized exclusively for one or more exempt purposes, without reference to its operations. This requirement relieves the Service of the obligation to look beyond the formal organizational papers to ascertain an organization's stated purposes.

Reg. 1.501(c)(3)-1(b)(1)(i) provides that an organization is organized exclusively for one or more exempt purposes only if its articles of organization limit its purposes to one or more exempt purposes and do not expressly empower it to engage, otherwise than as an insubstantial part, in activities which in themselves are not in furtherance of one or more exempt purposes.

Pursuant to Reg. 1.501(c)(3)-1(b)(2), the term "articles" means "the trust instrument, the corporate charter, the articles of association, or any other written instrument by which an organization is created." Accordingly, the organizational test cannot be met by reference to any document that is not the creating document. In the case of a corporation, the by-laws cannot remedy a defect in the corporate charter. A charter can be amended only in accordance with State law which generally requires filing of the amendments with the chartering authority. In the case of a trust, operating rules cannot substitute for the trust indenture. In the case of an unincorporated association, the test must be met by the basic creating document and the amendments thereto, whatever that instrument may be called. Subsidiary documents that are not amendments to the creating document may not be called on.

Accordingly, if the creating document expresses a purpose or authorizes an activity that is not described in or that is restricted by IRC 501(c)(3), then the organization will have failed the organizational test. However, Reg. 1.501(c)(3)-

1(b)(6) provides that an organization that was determined by the Service to be exempt before July 27, 1959, need not amend its creating document to meet the organizational test unless it seeks a new determination of its status; nor will its exemption be revoked solely for failure to meet the test.

4. Purposes

In meeting the organizational test, the organization's purposes as stated in its articles of organization, may be as broad as, or more specific than the particular exempt purposes, such as religious, charitable, or educational. Therefore, an organization which by the terms of its articles is formed "for literary and scientific purposes within the meaning of section 501(c)(3) of the Internal Revenue Code" shall, if it otherwise meets the requirements of the organizational test, be considered to have met the test. Similarly, articles stating that the organization is created solely "to receive contributions and pay them over to organizations which are described in section 501(c)(3) and exempt from taxation under section 501(a) of the Internal Revenue Code" are sufficient for purposes of the organizational test. Reg. 1.501(c)(3)-1(b)(1)(ii).

An organization is not organized exclusively for one or more exempt purposes if its articles expressly empower it to carry on, other than as an insubstantial part, activities which are not in furtherance of one or more exempt purposes, even though such organization is, by the terms of such articles, created for a purpose that is no broader than the purposes specified in section 501(c)(3). Thus, an organization that is empowered by its articles "to engage in a manufacturing business" or "to engage in the operation of a social club" does not meet the organizational test, regardless of the fact that its articles may state that the organization is created "for charitable purposes within the meaning of section 501(c)(3) of the Internal Revenue Code." Reg. 1.501(c)(3)-1(b)(iii). Also, Rev. Rul. 69-279, 1969-1 C.B. 152; Rev. Rul. 69-256, 1969-1 C.B. 151.

In no case will an organization be considered to be organized exclusively for one or more exempt purposes if, by the terms of its articles, the purposes for which such organization is created are broader than the specified charitable purposes. The fact that the actual operations of such an organization have been exclusively in furtherance of one or more exempt purposes is not sufficient to permit the organization to meet the organizational test. Similarly, such an organization will not meet the organizational test as a result of statements or other evidence that the members thereof intend to operate only in furtherance of one or more exempt purposes. Reg. 1.501(c)(3)-1(b)(1)(iv).

An organization is not considered organized exclusively for one or more exempt purposes if its articles expressly empower it to (1) devote more than an insubstantial part of its activities to attempting to influence legislation by propaganda or otherwise, (2) directly or indirectly participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of or in opposition to any candidate for public office, or (3) have objectives and engage in activities which characterize it as an "action" organization as defined in section 1.501(c)(3)-1(c)(3) of the regulations. Reg. 1.501(c)(3)-1(b)(3).

5. Dissolution

An organization is not organized exclusively for one or more exempt purposes unless its assets are dedicated to an exempt purpose. An organization's assets are dedicated to an exempt purpose if, for example, upon dissolution, the assets would, by reason of a provision in the organization's articles be distributed for one or more exempt purposes, or to the federal government. Similarly, if the assets would be distributed by a court to another organization to be used in a manner as in the judgment of the court will best accomplish the general purposes for which the dissolved organization was organized the assets are properly dedicated. However, an organization does not meet the organizational test if its articles or the law of the state in which it was created provide that its assets would, upon dissolution, be distributed to its members or shareholders. Reg. 1.501(c)(3)-1(b)(4).

The issue of the applicability of state law in relation to Reg. 1.501(c)(3)-1(b)(4) as to a particular organization arises only where the organization itself has not provided for the distribution of its assets upon dissolution in its articles of incorporation, organizing document, or trust instrument. When state law satisfies the provisions of the regulations, it is not necessary to require an organization to amend its articles of incorporation or organizing document, or to require a trust to obtain a judicial decree amending its trust instrument, in order to satisfy the organizational test for qualification as an exempt organization described in IRC 501(c)(3) where all the other requirements for exemption are met.

The cy pres doctrine is a principle of law that courts use to save a charitable trust from failing when a charitable objective becomes impossible or impracticable to fulfill. In such a case, the court may substitute another charitable object which is believed to approach the original charitable purpose as closely as possible. (The term cy pres comes from French law and means "so near" or "as near as possible".)

This legal doctrine is based on the theory that a court has the power to revise a charitable trust where the maker (also called the creator, settlor, or - in the case of a trust under a will - testator) had a charitable interest in order to meet unexpected emergencies or changes in conditions which threaten the trust's existence.

However, cy pres will not always be applied to save a charitable trust from failing where it is impossible to carry out the particular purposes of the testator. When it appears that the accomplishment of only a particular purpose was desired by the testator and that there was no general intent to benefit charity, the majority of courts will presume that the testator would prefer to have the whole trust fail if the particular purpose is or becomes impossible to accomplish.

In contrast, the majority of courts apply the cy pres doctrine when a testator makes a general bequest for charity, or for general charitable purposes, without specifying a particular purpose or beneficiary. In such a case, the court will choose a particular purpose for the disposition of the property in accordance with the testator's general charitable intent. The following example demonstrates how a state court might apply the cy pres doctrine to a specific factual situation:

X bequeathed his residuary estate to Hospital A for the benefit of tubercular children. When X died, Hospital A no longer existed and his heirs filed suit claiming that the legacy lapsed and the residuary estate passed to them by intestacy. The court held that the gift to Hospital A was a charitable bequest because the gift was not intended for a particular institution, but for the benefit of tubercular children as a class with the hospital as trustee. Since the purpose and objective for which the trust was created (treatment of tubercular children) still existed, even though the hospital did not, the legacy did not lapse because the cy pres doctrine applied. The court awarded the legacy to another local hospital as trustee for the benefit of tubercular children.

Rev. Proc. 82-2, 1982-1 C.B. 367, contains guidelines for identification of states and circumstances where the Service will not require an express dissolution provision in an organization's governing instrument because the state's law, whether statutory or court-made, is deemed adequate to guarantee dedication of assets to charitable use. The revenue procedure discusses the rules for nonprofit charitable corporations as well as trusts and unincorporated associations. It also contains language illustrative of what may be used by any organization that needs a dissolution provision in its organizing instrument to satisfy Reg. 1.501(c)(3)-1(b)(4).

6. Practical Applications

The following situations illustrate the requirements of the organizational test discussed above. In each case, assume the organizational test has otherwise been met.

SITUATION A

The articles state the organization is formed for "charitable purposes" without any further description.

DISCUSSION: Such language ordinarily will be sufficient since the term "charitable" has a generally accepted legal meaning. On the other hand, if the purposes are stated to be charitable, philanthropic, and benevolent, the organizational requirement will not be met since the terms philanthropic and benevolent have no generally accepted legal meaning and, therefore, the stated purposes may, under state law, permit activities that are broader than those intended by IRC 501(c)(3).

SITUATION B

The articles state that an organization is formed exclusively for "educational and literary purposes within the meaning of section 501(c)(3) of the Internal Revenue Code of 1954."

DISCUSSION: This language appropriately limits the organization's purposes by reference to IRC 501(c)(3) since the terms "educational" and "literary" are not terms of art and therefore, have no generally accepted legal meaning that has been established outside that context. The word "exclusively" is desirable, but not mandatory.

SITUATION C

The articles state the organization is formed "to engage in research" without further description or limitation.

DISCUSSION: Since not all research is "scientific," the purpose of the organization is not sufficiently limited to exempt purposes within the meaning of IRC 501(c)(3).

SITUATION D

The articles state the organization is formed "to promote American ideals and to further the common welfare and well-being of the community."

DISCUSSION: Without any limitation or provision restricting such purposes to accomplishment only in a charitable manner, the purposes are not sufficiently limited. Such purposes are vague and may be accomplished other than in an exempt manner.

SITUATION E

The organization was formed "to operate a hospital."

DISCUSSION: This provision does not meet the organizational test since a hospital may or may not be exempt as a charitable organization depending on the manner in which it is operated. If the organization's proposed operation is described in sufficient detail to establish that it will meet the requirements of Rev. Rul. 69-545, 1969-2 C.B. 117, the organizational test will be met.

SITUATION F

The organization's articles provide that it shall have all the powers conferred upon a corporation by the law of State X. One of the powers conferred is the power "to conduct business". The organization's articles provide that it shall be organized "not for profit".

DISCUSSION: Pursuant to Reg. 1.501(c)(3)-1(b)(iii) an organization which has the power to carry on substantial business activities cannot be said to be organized exclusively for exempt purposes within the scope of section 501(c)(3) even though the full extent to which a 501(c)(3) organization can engage in business pursuant to Reg. 1.501(c)(3)-1(e)(1) has yet to be determined.

SITUATION G

The applicant corporation was formed in the state of New York in 1958. Its articles do not limit its purposes to exempt purposes nor do they contain a proper dissolution clause, but the organization has at all times been operated for charitable purposes.

DISCUSSION: Although the organization was created prior to the effective date of the regulations, it has not been recognized by the Service as exempt under IRC 501(c)(3). Therefore, the organization must amend its articles to limit its purposes to IRC 501(c)(3) purposes and, since New York law does not satisfy the requirements of Reg. 1.501(c)(3)-1(b)(4), must add an adequate dissolution provision.

SITUATION H

An organization's articles provide that on dissolution its assets will be distributed "to the United Way", an existing 501(c)(3) organization.

DISCUSSION: Reg. 1.501(c)(3)-1(b)(4) provides that the assets must be dedicated to an exempt "purpose". Since a named beneficiary at the time of dissolution may not be qualified, may not be in existence, or may be unwilling or unable to accept the assets of the dissolving organization the articles should be amended to provide for distribution of the assets for one or more of the purposes specified in IRC 501(c)(3) in the event of any such contingency. A statement that the assets will be distributed for purposes identical to those purposes for which the organization was created will ordinarily suffice even without reference to IRC 501(c)(3).

SITUATION I

The organization is organized solely to receive contributions and pay any of its funds or income over to organizations which are described in section 170(c) of the Code.

DISCUSSION: The organizations listed in sections 170(c)(3), (4) and (5) are not necessarily described in section 501(c)(3) of the Code. Thus, the organization's purposes are broader than those permitted by

section 501(c)(3), and the organizational test is not met. See G.C.M. 31440, dated November 13, 1959.

SITUATION J

The articles of organization provide that the corporation can issue a total of 10,000 shares of \$1 par value common stock and that upon dissolution the shareholders who subscribe to this common stock will receive an amount equal to the par value of the shares.

DISCUSSION: This provision contravenes Reg. 1.501(c)(3)-1(b)(4) which requires the organization's assets to be permanently dedicated to exempt purposes.

Articles of organization that fail to meet the organizational test are ordinarily amendable. Exemption may, nevertheless, be retroactive to the period before amendment since such amendments are generally considered nonsubstantive in nature. See section 13.01 of Rev. Proc. 84-46, 1984-1 C.B. 541. Therefore, most applicants will agree to amend their articles, if necessary, to clear this relatively easy hurdle on the path to tax-exempt status under IRC 501(c)(3).

IRM 7668.2 sets forth procedures for the issuance of conditional exemption letters to organizations with flaws in their organizational instruments that have not already resulted in an operational deficiency. Generally, conditional rulings should be issued only to those organizations showing an exceptional need for tax exempt status within a short period of time and the organization is unable to receive state approval of its amended governing instrument within 90 days.